

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:HMT: :1:POSTF-142379-02
[REDACTED]

date: *August 5, 2002*

to: [REDACTED], Examination International Team Manager
Attn: [REDACTED]

from: [REDACTED]
Associate Area Counsel
(Large and Mid-Size Business)

subject: [REDACTED]: Fair Market Value Method vs. Tax Book Value Method of Apportionment

This memorandum responds to your request for assistance dated April 25, 2002, and as supplemented on June 10, 2002. This memorandum should not be cited as precedent.

ISSUES:

1. Whether taxpayer failed to establish the fair market value of its assets to the satisfaction of the Commissioner.
2. Whether the Commissioner may require taxpayer to use the tax book value method of apportionment.

CONCLUSIONS:

1. Given the facts at hand, we believe that the taxpayer failed to establish the fair market value of its assets.
2. Based upon the facts at hand, the taxpayer failed to establish the value of a substantial portion of its assets, permitting the Service to reject the taxpayer's election of the fair market value method and place the taxpayer on the tax book value method of apportionment.

FACTS:

[REDACTED] (" [REDACTED] ") is an [REDACTED] company headquartered in [REDACTED]. [REDACTED]'s [REDACTED] through [REDACTED] tax years are currently under audit by LMSB Examination. For the years under audit, [REDACTED] claimed foreign tax credits (FTC) in the amounts of \$ [REDACTED], \$ [REDACTED] and \$ [REDACTED], respectively, and filed Forms 1118 computing the allowable FTC.

According to the taxpayer, the value of its foreign and worldwide assets for each of the tax years were as follows:

<u>Assets Reported</u>			
<u>Tax Year</u>			
Worldwide Assets			
Foreign Assets			
Percentage Foreign Assets	%	%	%

Schedule H, Part II of Form 1118 allows the computation of the interest expense apportionment and contains the election to use either the fair market value or tax book value method of apportionment. elected the fair market value (the "FMV") method for , , and .³ Notwithstanding 's election to use the FMV method, Exam has been informed by the taxpayer that asset valuations were not conducted for any of the years

¹ Asset amounts were reported on the taxpayer's Forms 1118.

² It is worthwhile to note that the taxpayer's FMV determination did not consider that wrote down the assets by approximately \$ for book purposes.

³ While 's Schedule H elected the tax book value method, has stated that this was done in error and that FMV method was also applied to . In any event, once a taxpayer uses the fair market value method, the taxpayer and all related persons must continue to use that method unless expressly authorized by the Commissioner to change methods. Temp. Treas. Reg. § 1.861-8T(c)(2). has not been authorized by the Commissioner to use the tax book value method for its tax year.

under audit. The taxpayer explains this lack of appraisals by suggesting that its inside counsel advised against conducting asset valuations because of concerns that the valuations could have a negative affect on the company's requests with various regulatory agencies. suggests that the lack of appraisals is inconsequential since the financial statement book values used as a substitute for FMV were a conservative estimate of FMV.

On September 17, 2001, IDR # 22 was issued requesting specific information regarding the FMV method employed by . Included in this information request was a request for: (1) a general explanation of how the FMV was determined, (2) copies of any reports relied upon, (3) the names of the personnel involved, (4) any changes in application of the method within the years, (5) an explanation of why no valuations were conducted, and other similar relevant questions regarding this matter. While many of these basic questions relating to assumptions and procedures employed remain unanswered, the supporting documents offered by the taxpayer suggests the following asset values:

<u>Assets Reported</u>			
<u>Tax Years</u>			
Total Worldwide Assets	\$	\$	\$
Total Foreign Assets	\$	\$	\$
Percentage Foreign Assets	%	%	%

The taxpayer has not reconciled the differences between these asset value numbers and those reported for tax purposes on Forms 1118. Moreover, from the information submitted or provided orally by the taxpayer, it appears that used a different method for determining the value of its domestic assets then it did for its foreign assets. The taxpayer appears to have used financial book values for domestic assets while, for purposes of determining the value of its foreign assets, the taxpayer used its purchase price or ascribed no value at all.

On , the taxpayer's Director of International Tax, informed the Service that had engaged to provide an opinion (not a valuation) that FMV was equivalent to financial book value. On , a report from was finally received. The "limited review study" concluded as follows:

Based on the limited review analysis, the fair market value of the tangible assets in

a competitive market is indicated to be greater than their book value.

Report at 10. This conclusion is repeated two pages later.

The results of the investigation indicate that the fair market value of U.S. █ tangible assets is greater than or equal to their book value.

Report at 12.

ANALYSIS:

Section 901 allows a credit for foreign income, war profits, and excess profits taxes paid or deemed paid by qualifying taxpayers that elect the foreign tax credit in lieu of a deduction under section 164(a)(3). Section 904(a) limits a taxpayer's foreign tax credit to an amount equal to the pre-credit U.S. tax on the taxpayer's foreign source taxable income.

Sections 861(b), 862(b), and 863(a) provide that taxable income attributable to gross income from domestic or foreign sources shall be determined by deducting the expenses, losses, and other deductions properly apportioned or allocated thereto, and a ratable part of any expenses, losses and other deductions that cannot be definitely allocated to some item or class of gross income. Treas. Reg. §§ 1.861-8 through 1.861-17 provide specific guidance regarding the allocation and apportionment of deductions. Generally, deductions are allocated to classes of gross income and, as required by the operative section of the Code, apportioned between statutory and residual groupings of gross income.

The allocation and apportionment regulations emphasize the factual relationship between deductions and gross income. A deduction is considered to be definitely related to a class of gross income, and therefore allocable to such class, if the deduction is incurred as a result of, or incident to, an activity or in connection with property from which such class of gross income is derived. If a deduction is not definitely related to a class of gross income constituting less than all gross income, it is generally treated as allocable to all gross income.

In the case of interest expense, as is most relevant here, the regulations apply the factual relationship principle in a manner that emphasizes the fungibility of money. As Treas. Reg. § 1.861-9T(a) explains:

The method of allocation and apportionment for interest set forth in this section is based on the approach that, in general, money is fungible and that interest expense is attributable to all activities and property regardless of any specific purpose for incurring an obligation on which interest is paid. Exceptions to the fungibility rule are set forth in § 1.861-10T. The fungibility approach recognizes that all activities and property require funds and that management has a great deal of flexibility as to the source and use of funds. When money is borrowed for a specific purpose, such borrowing will generally free other funds for other purposes, and it is reasonable under this approach to attribute part of the cost of borrowing to such other purposes. Consistent with the principles of fungibility, except as otherwise provided, the aggregate of deductions for interest in all cases shall be considered related to all income producing activities and assets of the taxpayer and, thus, allocable to all the gross income which the assets of the taxpayer generate, have generated, or could reasonably have been expected to generate.

Since the Tax Reform Act of 1986, all allocations and apportionments of interest expense have been required to be made on the basis of assets rather than gross income. See section 864(e)(2). Under section 864(e)(1), the taxable income of each member of an affiliated group is determined by allocating and apportioning interest expense of each member as if all members of the group were a single corporation.

Under the asset method, interest expense is apportioned between statutory and residual groupings of gross income (or among statutory groupings) in proportion to the average total values of the assets within each such grouping for the taxable year. Treas. Reg. § 1.861-9T(g)(1)(i). This average is generally computed on the basis of values at the beginning and end of the year; however, under certain circumstances, a different method must be used. Treas. Reg. § 1.861-9T(g)(2).

Taxpayers may elect to value their assets based on their tax book value or fair market value. Treas. Reg. §§ 1.861-8T(c)(2) and 1.861-9T(g)(1)(ii). This election is generally indicated by marking a box on Schedule H of Form 1118, as was done here. As provided by Treas. Reg. § 1.861-8T(c)(2), with a limited exception not relevant here, once a taxpayer elects to use the fair market value method, the taxpayer and all related persons must continue to use such method unless expressly authorized by the Commissioner to change methods.

A taxpayer that elects to apportion interest expense under the fair market value method must establish the fair market value of its assets to the satisfaction of the Commissioner. Treas. Reg. § 1.861-9T(g)(1)(iii). In short, the taxpayer must determine the value of all its assets as of the last day of the taxable year for each year it uses the fair market value method to apportion its interest expense. Treas. Reg. § 1.861-9T(g)(3). Finally, if a taxpayer fails to establish the fair market value of an asset to the satisfaction of the Commissioner, the Commissioner may determine the appropriate asset value. Treas. Reg. § 1.861-9T(g)(1)(iii).

Of equal importance, Treas. Reg. § 1.861-9T(h) specifies the overall methodology which must be followed for all valuations of assets under the fair market value method. Basic to the required methodology is the premise that all valuations must be made using generally accepted valuation techniques. Treas. Reg. § 1.861-9T(h)(ii). However, if a taxpayer fails to establish the value of a "substantial portion" of its assets to the satisfaction of the Commissioner, the Commissioner may require the taxpayer to use the tax book value method of apportionment. Treas. Reg. § 1.861-9T(g)(1)(iii).

Issue 1:

In considering whether taxpayer failed to establish the fair market value of its assets to the satisfaction of the Commissioner, the facts surrounding the actions of the taxpayer are telling.

First, the taxpayer does not even suggest that it performed a fair market value study of its assets. Instead, it purported to elect the fair market value method by checking the corresponding box on Schedule H of its Forms 1118. However, [REDACTED] used one method to assign a value to its domestic assets (financial statement book value) and a different method to assign a value to its foreign assets (fair market value based on cost data). In addition to using different methodologies, both methodologies used are flawed. Most easily identified are the flaws in the domestic values assigned. The study [REDACTED] performed for the taxpayer did not examine the taxpayer's actual assets. In fact, except to note the total book value of the [REDACTED] in service (Report at 10), the study neither specifically addresses nor mentions the value of [REDACTED]'s assets. Instead, the study looked at assets of [REDACTED], generally. Whether the taxpayer's own assets correlate closely to those considered by the study is unknown.

Moreover, the book values assigned to domestic assets are, by the taxpayer's own study, less than or equal to the assets' fair market values. However, without valuing its assets, whether the book values are less than the assets true fair market value cannot be known. In short, the book values suggested by the taxpayer simply do not equate to the fair market values of the domestic assets and cannot be used as a replacement for the fair market values.

In addition, the taxpayer's methodology to assign a value to its foreign assets, which methodology uses most recent acquisition cost data as a proxy for the assets' fair market value, is also flawed. First, according to the International Examiner, certain foreign assets appear to have been ignored for purposes of the assignment of a fair market value.

Second, there is no indication that the instant taxpayer has applied the fair market value method as required by Temp. Treas. Reg. § 1.861-9T(h). For example, taxpayers are required to subtract the value of its tangible assets from the value of its entire corporation as determined by reference to the trading value of the taxpayer's stock multiplied by the number of its shares outstanding and increased by the taxpayer's year-end liabilities to unrelated persons and its pro-rata share of year-end liabilities of all related persons owed to unrelated persons. Third, taxpayer failed to explain why its \$ [REDACTED] write down (assuming such write down is, in some way, reflective of value) of the [REDACTED] assets in [REDACTED], the year after it acquired that asset, had no effect on the "fair market value" it assigned to those assets for purposes of the allocation. Fourth, the taxpayer has failed to adjust the purchase price in years following the year of acquisition, notwithstanding apparent appreciation or depreciation of the assets.

Finally, the use of inconsistent methods for valuing assets producing income from foreign sources and the use of a different method to value assets producing U.S. source income would result in a skewed apportionment of interest expense. For this reason, the regulations require that apportionment of interest expense be made either on the basis of the tax book value or the fair market value with respect to all assets.

As a result of the foregoing, we have no doubt that the facts portray the failure on the part of the taxpayer to establish the fair market value of its assets. Your conclusion to the same effect is well justified.

Issue 2:

In considering whether the facts at hand justify putting the taxpayer on the tax book value method of apportionment, one only needs to look at the flawed methodology used by the taxpayer to reach a conclusion. Neither the methodology used for assigning a fair market value to domestic assets nor the separate methodology used for assigning a fair market value to foreign assets is accurate. Both methodologies used are flawed. The taxpayer has failed to establish the fair market value of **any** of its assets, domestic or foreign.⁴ As a result, the taxpayer has failed to establish the value of a "substantial portion" of its assets to the satisfaction of the Commissioner, and the Commissioner may require the taxpayer to use the tax book value method of apportionment. Treas. Reg. § 1.861-9T(g)(1)(iii).

Conclusions:

The shortcomings discussed above are sufficient in magnitude and importance to justify the conclusion that the taxpayer failed to establish the fair market value of its assets to the satisfaction of the Commissioner. Moreover, because the taxpayer failed to establish the fair market value of any of its assets, it is appropriate to conclude that the taxpayer failed to establish the value of a "substantial portion" of its assets to the satisfaction of the Commissioner, justifying the requirement that the taxpayer use the tax book value method of apportionment, consistent with Treas. Reg. § 1.861-9T(g)(1)(iii).

⁴ Even assuming that taxpayer established the value of its foreign assets through the use of recent cost data as a proxy to fair market value, as reported on its Forms 1118, the total value of █████'s foreign assets does not exceed █████% of the value of its worldwide assets during any of the years at issue. █████'s failure to establish the fair market value of the other █████% of its assets is clearly a failure to establish the fair market value of a "substantial portion" of its assets under Temp. Treas. Reg. § 1.861-8T(c)(2).

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

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